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Nos. 89-1926; 89-1927; 89-1928

In The

Supreme Court of the United States

October Term, 1989

United States of America,

v. *Petitioner,*

Centennial Savings Bank FSB
(Resolution Trust Corporation, Receiver)

United States of America,

v. *Petitioner,*

First Federal Savings and Loan Association of Temple

Commissioner of Internal Revenue

v. *Petitioner,*

San Antonio Savings Association And Subsidiaries
(Resolution Trust Corporation, Receiver)

Amicus Curiae Brief Of The U.S. League Of Savings Institutions Filed In Opposition To The Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

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QUESTION PRESENTED

Whether a loss from an exchange of mortgage loans involving a complete transfer of ownership rights by both parties can be disallowed as not sustained under Section 165 of the Internal Revenue Code if the loss is realized and recognized within the meaning of Section 1001 of the Code.

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PURPOSE OF THIS AMICUS CURIAE BRIEF

This brief is submitted as a Brief in Opposition, pursuant to Rules 15 and 37 of this Court's Rules, in three cases from the United States Court of Appeals for the Fifth Circuit for which the Acting Solicitor General on

behalf of the United States (petitioner) has requested a writ of certiorari.[1] This brief is submitted on behalf of the respondent taxpayers.

The United States League of Savings Institutions ("U.S. League"), as amicus curiae, respectfully requests that the petitions for writ of certiorari sought by the petitioner be denied. If, however, the Court decides to grant review to the tax issue involving the deductibility of losses from exchanges of mortgage loans, this brief is intended to serve two purposes:

1) To correct petitioner's statement of the Question Presented with regard to the issue involving exchanges of first mortgage residential loans; and

2) To suggest to the Court which of the cases in the three appeals courts involving exchanges of loan portfolios should receive plenary review.[2]

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[1] The parties in the three above referenced cases have all consented in writing to the filing of this brief amicus curiae. *See* Sup. Ct. R. 37. The written consents have been filed with the clerk of the Court. The Fifth Circuit cases are *San Antonio Savings Association v. Commissioner*, 887 F.2d 577 (5th Cir. 1989); *Centennial Savings Bank v. United States*, 887 F.2d 595 (5th Cir. 1989); and *First Federal Savings and Loan Association of Temple v. United States*, 887 F.2d 593 (5th Cir. 1989).

[2] This brief also addresses petitioner's petition for a writ of certiorari in *Federal National Mortgage Association v. Commissioner*, 896 F.2d 580 (D.C. Cir. 1990) ("FNMA") filed in this Court on June 19, 1990; and the taxpayer's petition for a writ of certiorari on the mortgage exchange issue in *Cottage Savings Association v. Commissioner*, 890 F.2d 848 (6th Cir. 1989) ("Cottage Savings").

INTEREST OF THE U.S. LEAGUE OF SAVINGS INSTITUTIONS AS AMICUS CURIAE

The United States League of Savings Institutions is the nationwide trade association representing the interests of savings institutions. Those institutions serve the nation's housing finance, savings and related financial service needs. Its membership as of June 28, 1990, includes 2,374 savings and loan, savings bank and cooperative bank institutions from every State, the District of Columbia, Puerto Rico, the Virgin Islands and Guam; 30 savings and loan holding companies; 165 associate members (typically law, accounting and other supplier firms to the industry); and 60 State and regional organizational members.[3]

The purposes of the U.S. League are to encourage a political, economic and social climate in which savings institutions can operate profitably, so that member institutions can effectively serve the financial needs of the American public. The U.S. League represents the collective views of its members before Congress, the executive branch of government, federal regulators and other

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[3] The nationally elected officers for 1990 are Kenneth D. Seaton of Hancock, MI, Chairman, and Robert B. O'Brien, Jr. of Newark, NJ, Vice Chairman. Principal staff include Frederick L. Webber, President and Chief Executive Officer; Brian Smith, Executive Vice President & Deputy, Chicago Office; Denis O'Toole, Executive Vice President-Government Affairs; and Philip Gasteyer, Executive Vice President & General Counsel. The League's office locations are 1709 New York Avenue, N.W., Washington, D.C. 20006, and 111 East Wacker Drive, Chicago, IL 60601.

appropriate bodies. On occasion, it participates as *amicus curiae* in litigation of widespread interest and significance to its membership.

Many members of the U.S. League are involved in pending tax audits and litigation in U.S. Tax Court and other courts around the country involving tax deductions from exchanges of first mortgage residential loans. This is an issue of real magnitude for the entire thrift industry as it involves 96 cases and the interest on $419 million in taxes. The principal amount of these taxes is merely deferred from the deduction year to later years.

The U.S. League filed *amicus curiae* briefs on the mortgage exchange issue, which is the subject of the instant brief, in the Fifth Circuit in *San Antonio Savings Association v. Commissioner,* in the U.S. Tax Court proceedings involving that case, and also in the U.S. Tax Court proceedings involving Cottage Savings Association and the Federal National Mortgage Association, which cases are the subjects of separate petitions for a writ of certiorari before this Court.

COUNTERSTATEMENT OF THE QUESTION PRESENTED

In his petitions in the *San Antonio, Centennial* and *First Federal* cases, petitioner states the Question Presented as follows:

> "Whether a financial institution realizes a deductible loss for income tax purposes when it exchanges a group of mortgage loans for a substantially identical group of mortgage loans held by another financial institution."

This formulation of the issue is incorrect for three reasons.

1. The question of whether a financial institution "realizes" its loss from exchanging groups of mortgage loans is not in conflict among the three Circuit Courts which have addressed this tax deduction question. The Fifth, Sixth and District of Columbia Circuits all agree that each taxpayer *realized* their respective losses under Section 1001(a) and *recognized* those losses under Section 1001(c) of the Internal Revenue Code.[4] If this Court chooses (as we believe it should) to concentrate on the

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[4] The Sixth Circuit stated in *Cottage Savings:*

> "We believe the loss in this case was technically realized in the sense that an earlier decline in value of the fixed-rate mortgage loans was fixed by an identifiable event – the 'reciprocal sales' transaction. Since there is no Code exception that applies, under § 1001(c) the loss must be recognized." 890 F.2d at 852.

Similarly, the Fifth Circuit stated in *San Antonio:*

> "We uphold the finding of the tax court allowing SASA the deduction of $14,956,898 under the Internal Revenue Code as loss realized through the exchange of materially different property." 887 F.2d at 593.

All three appeals courts also agreed that a business purpose is not required in order for a seller of property which has declined in market value to sell or exchange the asset in order to realize his loss for tax purposes. The U.S. Tax Court unanimously held for the taxpayers on the realization issue and rejected all of the Commissioner's arguments.

Unless otherwise indicated, statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.) as in effect for the years at issue ("Code").

area of conflict among the appeals courts concerning deductibility of the losses, realization of the loss is not the technical matter which needs resolving by this Court. Petitioner is merely seeking to prolong litigation over tax realization rules in still another forum after having lost that battle decisively in all three appellate courts involved here.

The Question Presented on which the Sixth Circuit disagrees with the Fifth Circuit and District of Columbia Circuit concerns only the role of Section 165 of the Code in allowing or disallowing the losses in these cases. The Section 165 issue is discussed at pages 9-10, below.

2. Even as a statement of the realization issue involved in exchanges of loan portfolios, petitioner's formulation of the Question Presented is question-begging in referring to the mortgages received as "substantially identical." In his various petitions to this Court, petitioner does not argue or establish that "substantial identity" between or among the mortgages is a relevant legal standard under the *realization* provisions of Section 1001 and the related regulations.[5] The basic realization issue

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[5] A "substantially identical" test appears in the loss disallowance provisions of § 1091 (relating to so-called wash sales). The Tax Court squarely rejected the applicability of § 1091 to exchanges of mortgage loans in *FNMA v. Commissioner*, 90 T.C. 405, 425 (1988), *aff'd on other grounds*, 896 F.2d 580 (D.C. Cir. 1990). The Commissioner thereafter ceased making any § 1091 argument in any of these cases. Petitioner does not invoke § 1091 in any of his petitions in this Court on the mortgage exchange issue. In any event, the Commissioner has long ruled that different issuers of stock or securities prevent substantial identity under the wash sale provision of § 1091. *See, e.g.*, Rev. Rul. 59-44, 1959-1 C.B. 205; *see also Hanlin v. Commissioner*, 108 F.2d 429 (3rd Cir. 1939), *aff'g*, 38 B.T.A. 811 (1938).

framed by both the taxpayers and the Commissioner of Internal Revenue ("Commissioner") in the three appeals courts, as well as in the lower courts in all of these cases, is whether the mortgages transferred and received were "materially different" from each other "in kind or in extent" within the meaning of Treas. Reg. § 1.1001-1(a) or whether gain or loss is realized directly under Section 1001. The Fifth Circuit, Sixth Circuit and District of Columbia Circuits all agree that the losses in each of the cases were realized and recognized within the meaning of Section 1001. All three appeals courts based that conclusion on their view that the losses were *realized* under the "material difference" standard by reason of the fact of different debtors and collateral on both sides of the exchange; and that the realized losses were *recognized* under Section 1001(c), there being no nonrecognition provision elsewhere in the Code overriding that provision. None of the three appeals courts tested the exchanges by a "substantially identical" standard under Section 1001, or held that the financial accounting label used in

Memorandum R-49 of the Federal Home Loan Bank Board is legally relevant to realization of gain or loss under the tax law.[6]

Petitioner's reference to "substantial identity" in his version of the Question Presented is nothing other than a disguised contention that the regulatory accounting rule in Memorandum R-49 (describing the mortgages received as "substantially identical") controls realization or non-realization of gain or loss under the tax code (Section 1001). That specific proposition, however, is one on which all three appeals courts rejected the Commissioner's argument. This Court has long ruled that financial

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[6] The Government's Petition in *Centennial* misstates the holding of the Fifth Circuit in *San Antonio* and *Centennial*. The Government states:

> "In this case (and in its decision in the lead case of *San Antonio Savings Ass'n v. Commissioner*, 887 F.2d 577 (1989)), the Fifth Circuit has held that pools of mortgages *regarded as 'substantially identical' by the parties* and by the Federal Home Loan Bank Board under Memorandum R-49 are nonetheless 'materially different' for tax purposes." (Govt. *Centennial* Pet. 11) (emphasis added).

The taxpayers in both *Centennial* and *San Antonio* did not "regard" the mortgage groups as substantially identical for any purpose. For regulatory accounting purposes they simply complied with the criteria of Memorandum R-49. Their subjective views were immaterial for R-49 purposes.

The taxpayers also had no occasion to "regard" the groups as substantially identical for income tax purposes, because (as we have noted) no statutory provision or regulation under the Internal Revenue Code established "substantially identical" as a tax test of realization, recognition, or allowance of the deduction. None of the three Fifth Circuit decisions states that the taxpayers "regarded" the mortgage groups as substantially identical to each other.

accounting rules serve different purposes than tax rules, and do not determine tax results. *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 542-544 (1979).[7]

3. The Sixth Circuit differed from the other two circuits with regard to interpreting and applying Section 165 (relating to the general allowance of loss sustained during the taxable year and not compensated for by insurance or otherwise). In a relatively short and non-analytic discussion, the Sixth Circuit held that a loss can be treated as not "sustained" for purposes of Section 165 even though it is realized and recognized under Section 1001, and that Cottage Savings did not sustain its loss because it did not "change its economic position" as a result of the exchange. The Sixth Circuit adopted the notion that in order to sustain a loss for tax purposes, a taxpayer must be economically "poorer" after the exchange than he was before the exchange. The court

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[7] The Fifth Circuit held that mortgages can be "materially different" for tax purposes while being "substantially identical" within the meaning of Memorandum R-49 for regulatory accounting purposes. *San Antonio*, 887 F.2d at 591. Further support for this proposition, and specific examples, will be discussed in the substantive briefs the U.S. League plans to file on the mortgage exchange issue.

If this Court should decide to review whether each taxpayer *realized* his loss within the meaning of § 1001, the Court should consider whether District Judge Smith in *First Federal* and concurring Judge Cohen in the U.S. Tax Court provide a correct analysis that Treas. Reg. § 1.1001-1(a) does not have significance independent of § 1001 of the Code. In this view, under common law concepts, gain or loss is realized from an exchange unless the exchanged properties represent the same property rights.

reasoned that Cottage Savings was not "poorer" because it received loan receivables which were "substantially identical" to those sold, basing that conclusion on the terminology of the Federal Home Loan Bank Board's Memorandum R-49. The unexamined assumption is that regulatory accounting labels control the "sustaining" of loss under Section 165.[8] The Fifth Circuit, by contrast, held that Section 165 requires only that the losses resulted from a bona fide decline in market value of the mortgages (on account of an increase in new mortgage interest rates) and were fixed by a complete transfer of ownership rights between unrelated parties. There is no "substantial identity" test under Section 165, according to the Fifth Circuit. See *San Antonio*, 887 F.2d at 592-93.

In light of these two different interpretations, the real issue is whether the losses can be disallowed *under Section 165.*[9]

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[8] The Sixth Circuit appears to have been unaware of the express provisions of Treas. Reg. § 1.1001-1(a), which state that if a sale or exchange is considered to involve materially different property, the gain or loss "is treated as income or as loss sustained."

[9] The technically correct path to deducting the losses, we believe, is that a loss must first be sustained under § 165 in the sense of involving a bona fide transfer of full ownership rights to property, and *then* if an exchange is involved, the loss must be realized and recognized under § 1001. The § 165 tests precede rather than follow the realization test under § 1001. Unlike certain tax shelter cases, the losses here were not manufactured by the taxpayers to obtain tax deductions; the losses resulted from an increase in home mortgage interest rates during the late 1970s and early 1980s and the corresponding devaluation of loans held in thrift portfolios.

Since the meaning and application of Section 165 is the only legal issue over which the three appeals courts disagreed on exchanges of loan portfolios, we submit the Question Presented is stated more accurately as follows:

> Whether a loss from an exchange of mortgage loans involving a complete transfer of ownership rights by both parties can be disallowed as not sustained under Section 165 of the Internal Revenue Code if the loss is realized and recognized within the meaning of Section 1001 of the Code.

SELECTION OF CASES FOR PLENARY REVIEW

This is one of the relatively few situations where multiple petitions are before this Court on the identical issue. The various decisions on the deductibility of losses from exchanges of loan portfolios present a "menu" of contexts, lower court decisions and judicial approaches. These decisions can be summarized as follows:

FIFTH CIRCUIT	FEATURE	CIRCUIT DECISION
First Federal	Follows *San Antonio* on mortgage exchange issue	Affirms U.S. District Court, W.D. Texas
San Antonio (in receivership)	Principal opinion in Fifth Circuit	Affirms Tax Court
Centennial (in receivership)	Follows *San Antonio* on mortgage exchange issue. Also involves penalty income issue.	Reverses U.S. District Court, N.D. Texas
SIXTH CIRCUIT		
Cottage	Agrees loss is realized and recognized, but disallows deduction under § 165	Reverses Tax Court
D.C. CIRCUIT		
FNMA	Follows rationale in *San Antonio*	Affirms Tax Court

In his petitions for certiorari in the Fifth Circuit cases, as well as in *FNMA v. Commissioner*, petitioner asks that plenary review be given by this Court only to the *Centennial* and *First Federal* decisions.

Petitioner argues that this Court should not give plenary review to *San Antonio* because of "uncertainty" over whether that thrift's entry into receivership in July 1989, and the fact that San Antonio has not yet paid the tax deficiency, renders the exchange issue "moot" in that case. He argues that a collectibility issue does not exist in *Centennial* because that taxpayer paid its tax and then sued for refund in the U.S. District Court. Petitioner asks for plenary review in both *Centennial* and *First Federal* presumably in order to place before this Court one case involving an insolvent savings and loan association and one involving a solvent savings and loan, respectively. This is a distinction without a difference. The substantive tax issues involved in deciding whether losses are deductible from exchanges of loan portfolios are not affected by a taxpayer's solvency. There is no substantive reason for this Court to give plenary review to the deduction issue because a thrift is insolvent or in receivership.

The U.S. League believes that the Court should select those one or more cases most representative of the taxpayers affected by the issue and its ramifications, and which will give the Court the opportunity to hear the fullest adversary presentation of arguments on both sides of the issue. It should be noted that in the *Centennial* and *San Antonio* cases, where the taxpayer is in receivership, a governmental agency is represented on both sides of the issue.

For reasons stated below, we believe that if the Court decides to hear the mortgage exchange issue, it should

grant plenary review to the *First Federal* and *Cottage Savings* decisions. Both cases involve solvent savings and loan associations and private taxpayers having a real financial stake in the wide array of business transactions impacted by the tax collector's position.

The mortgage exchange issue raises fundamental questions of tax common law involving threshold concepts of realization and recognition of gain and loss which this Court has not reconsidered since the early 1920s. The tax issue broadly affects exchanges of secured debt obligations and other like kind assets. The Commissioner and the Sixth Circuit would radically upset the long-settled tax concepts of *realizing* and *recognizing* loss from a sale or exchange of property and the meaning of *sustaining* a loss under Section 165 of the tax code. If the Commissioner's argument in these cases and the Sixth Circuit's holding in *Cottage Savings* on Section 165 are accepted by this Court, the adverse impact on the healthy portion of the thrift industry and on business transactions generally would be far-reaching. The relation between the "sustained" provision of Section 165 and the realization and recognition requirements of Section 1001 has serious implications for (1) all taxpayers deducting business losses of all kinds (must any seller be "poorer" after the sale?); (2) commonplace year-end sales of stocks and bonds designed to realize investment losses offsetting gains during the same year; and (3) distinguishing "tax shelters" where losses are "manufactured" rather than produced by bona fide declines in market value. Petitioner's own position that income or loss is not realized if a taxpayer buys similar property has vast *revenue-losing* potential for the Government since solvent sellers of all

types of property can use the Commissioner's own arguments to contend for nonrealization of *business gains*.

The important consideration, we submit, is to select for plenary review the case or cases involving taxpayers who actually or potentially have a financial stake in all of these ramifications of the Government's, and of the Sixth Circuit's, position on mortgage exchanges. Hearing arguments from such a taxpayer – opposed by the governmental interest represented by the Solicitor General on behalf of the Internal Revenue Service – is, we believe, the best way to focus all pertinent aspects of this tax issue for the Court's benefit. *Cf. Baker v. Carr*, 369 U.S. 186, 204 (1962) ("concrete adverseness . . . sharpens the presentation of issues upon which the court so largely depends for illumination of difficult constitutional questions"). Certainly, full adversarial status can be achieved here by full review of the case or cases in which wholly private counsel opposes the governmental interest represented by the Solicitor General.

The cases best presenting the appropriate adversarial interests on the mortgage exchange issue are *First Federal* and *Cottage Savings*.[10]

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[10] The Court, we believe, can accept our recommendation on the mortgage exchange issue while hearing *Centennial* solely on the separate issue of penalty income from early withdrawal of time deposit accounts (if the Court otherwise decides to review that subject).

If this Court should be inclined to grant plenary review to the *FNMA* case, the Court should be aware that FNMA is not a regulated savings and loan institution and was not subject to Regulatory Memorandum R-49. If the Court chooses to give plenary review solely to *FNMA*, the Court should satisfy itself that it can still consider the sub-issue of the effect, if any, of regulatory accounting rules on the deductibility of a loss under § 165 and/or on the criteria for realization of loss under § 1001.

CONCLUSION

Regarding the mortgage exchange issue, the Question Presented should be revised as stated in this brief rather than as stated by petitioner.

If this Court grants certiorari on the mortgage exchange issue arising in the Fifth, Sixth and District of Columbia Circuits, plenary review should be granted in the *First Federal* and *Cottage Savings* cases or, alternatively, in all of the cases raising the issue from the three appeals courts.

Respectfully submitted,

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